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1035 Exchanges and Replacements

Manufacturers of annuities continue to respond to the demands of the marketplace with new product ideas, new features, and new marketing approaches that are geared toward the needs of today's retirees and persons approaching retirement. As new features are introduced, owners of legacy products are sometimes intrigued by these fresh benefits when approached by advisers. The lure of the new product sometimes results in a request to terminate the old to acquire the new. It is this process of exchanging one [contract](#) for another that we will examine in this section. Its common name is replacement, and the IRS concept of 1035 exchanges plays a key role in making it occur.

A. Annuity Replacements

The replacement process can benefit customers immensely, resulting in the acquisition of a product with stronger benefits and more appropriate features. However, it can also be driven by advisors who are selfishly motivated by additional opportunities for compensation. Because of some questionable sales situations involving product replacements and unscrupulous financial representatives, there is substantial regulatory focus on customer protection. The practice of unnecessarily replacing an existing [insurance policy](#) or annuity contract with a new policy from the same or a different carrier to generate a new commission for the producer is a violation of state replacement laws. This prohibited practice is known as [churning](#).

FINRA has been on the forefront of advising financial consumers to be on the alert for churning with regard to variable annuities, and has published this message on its investor website:

"Variable annuity sales have dropped along with the decline in the equity marketplace. A recommendation for the exchange of an existing annuity contract for a new annuity contract may be the only way a salesperson can generate additional business. However, the new variable annuity contract may have a lower contract value and a smaller [death benefit](#). As in any circumstances, you should exchange your annuity only when it is better for you and not just better for the person trying to sell you a new annuity."

There are certainly times when replacement of an existing contract is appropriate. The following are circumstances that might warrant [consideration](#) of replacement:

- The new contract offers a bonus on purchase payments that greatly enhances the earnings in the contract;
- The new contract has investment options that are not available in the existing contract;

- Better features for lower fees and charges;
- Enhanced death benefits; or
- The living benefit choices are more attractive.

There are also times when replacement is clearly not in the best interest of the customer. Let's review some of those examples:

- Attractive benefits of the old contract are not available in the new contract; for example, the old contract includes higher minimum guarantees or death benefits.
- New surrender charges apply, which will limit contract liquidity.
- New contract acquisition requires costs that may impact the benefits.
- Appealing bonus payments are offset by high charges.
- Although many new and robust features are included in the contract, the customers do not need them to achieve their investment objectives.

The higher commission paid for the sale of an annuity product has resulted in the representative limiting the introduction and offer of other financial products that could be better suited to the situation.

In any case, the replacement of an annuity should only take place when it is determined that **it is in the best interest of the customer**, as in the following situations:

- A customer has identified a new financial need that the existing product cannot meet.
- A different product can better meet the customer's changing financial needs, goals or risk tolerances.
- A new product has a better price and/or benefits.

Careful evaluation of the benefits of the new contract, as well as the impact to the old, should precede any replacement activity.

1. When Does a Replacement Occur?

The industry definition of replacement is broader than one might immediately expect. It is understandable that the termination of one annuity [contract](#) to purchase another annuity contract with similar features is defined as a replacement, but other contract changes are also within the definition. *For example*, changes to life insurance contracts can be considered replacements if these changes are made to make funds available for the purchase of an annuity.

Generally, a replacement occurs when a new contract is purchased, and to complete the sale, an existing policy is

- Surrendered, lapsed, forfeited, or terminated in any way;
- Converted to a reduced paid-up policy, continued as extended term insurance, or otherwise reduce in value by use of nonforfeiture benefits or other policy values;
- Amended to reduce benefits or terms;
- Reissued with a reduction of cash value;
- Borrowed against, and a loan amount of more than 25% of the loan value is requested (whether as a single loan or a schedule of borrowing over a period of time); or
- Pledged as collateral for a loan.

2. Considerations in the Replacement Process

Before proceeding with a replacement for the purchase of an annuity [contract](#), the impact of the decision should be carefully considered with the customer. The following list of questions is helpful in this process.

Contract values:

- Acquisition cost for the old policy may have been paid; what are these costs for the new contract?
- What surrender charges do the policies have? What expense and sales charges will be paid on the new contract?
- Does the new policy provide more or less death benefit?

Insurability (relevant if a life [insurance policy](#) is being replaced):

- Has health has changed since the purchase of the old policy? If so, no new coverage may be available.
- The future purchase of a new life insurance policy may require medical examination and will restart the suicide provision.

If the owner keeps the old policy and purchases a new annuity:

- Are purchase payments or premiums for both contracts affordable?
- How will this affect the payments on the existing policy?
- Will a loan reduce any expected death benefits?
- What values from the old policy are being used to pay premiums?

If surrendering an annuity or interest-sensitive life product:

- Will surrender charges be payable on the old contract?
- What are the interest rate guarantees for the new contract?
- How do contract charges or other policy expenses on the new contract compare to the old?

Other issues to consider for all transactions:

- What are the tax consequences of the transactions?
- Is this a tax-free exchange? (See your tax adviser)
- Are there any beneficial "grandfathered" federal tax treatments of the old contract that may the owner is giving up?
- How does the quality and financial stability of the new company compare with the existing company?
- Is the company that issued the contract as financially strong as it was in the past?

3. Responsibilities of the Agent in a Replacement Sale

When proceeding with the replacement of a [contract](#) for the sale of an annuity, financial representatives must ensure compliance with applicable state law.

Representatives are required to disclose all aspects of a replacement sale to the customer. In the process, the representative must complete documentation of the objectives, rationale and suitability for the replacement, and any associated costs.

Typically a "**Notice Regarding Replacement**" form must be read to the [applicant](#) and then signed by both the representative and the applicant. The agent must leave a copy with the applicant and submit it with the [application](#). The applicant should also be given copies of any written or printed sales material, illustrations or proposals that were used in the sales process.

Representatives must maintain complete files to document their needs analysis and their resulting recommendations.

These procedures apply in replacement of both the policies of other companies, and any policies of the same issuer.

4. Responsibilities of the Insurer

The insurance company that will issue the new annuity **contract** must follow the internal guidelines and state-specific replacement regulations in the sale. All required forms must be accounted for and reviewed in the issue process. The insurer must prepare and require the appropriate **disclosure** forms for financial representatives to provide to purchasers.

Further, reviews of representative business practices are conducted to ensure proper business practices have been followed and necessary documentation has been maintained. Under new replacement regulations, issuing companies are required to "monitor" replacement activity and actively seek out replacements that have not been properly disclosed as replacements by either the client or agent. These "unreported" replacements must be tracked separately for each agent and are subject to review internal and by the state department of insurance.

The new company must also promptly send a "Notice of Proposed Replacement of Life Insurance or Annuity" to the customer's existing insurer stating that an existing policy is to be replaced. This notice must include a signed acknowledgement by the agent.

B. California Annuity Replacement Regulations (CIC 10509-10509.9)

Replacement is defined as the purchase of a new individual life insurance or a new annuity **contract** which will result in another policy or contract with another insurer to be lapsed, surrendered, terminated, forfeited, converted to another type of policy (*for example*, exercising a nonforfeiture option), or have the benefits reduced. When a replacement is involved (whether the new agent knows for sure or should reasonably suspect so), extra requirements apply. These include disclosures and notification to the client.

The nature of these replacement guidelines includes the following:

- Making sure the purchaser can make a complete and fair comparison between the two products to make the best decision;
- Reducing the opportunity to make misrepresentations and incomplete disclosures and evaluations; and
- Establishing penalties for failure to comply with these measures.

1. Requirements

During the time of taking the **application** and underwriting, **an agent** must do the following:

- When the client already has life insurance, the applications will require a signed statement by the client confirming his or her intentions to replace, as well as a signed statement from the agent determining whether he or she knows/suspects that a replacement may be involved. The application will ask for information on all current life insurance policies the client has.
- If there may be a replacement, there is another separate **disclosure** form, a "Notice Regarding Replacement of Life Insurance." This must be signed by the client and agent at time of application. On this form detailed information may also be listed concerning the current policy, including name and address of the current insurer(s), as well as policy number and amounts of coverage. A copy of this form (often a triplicate form) is to be left with the client for their records. Another must be sent in with the application, and the agent/branch office may retain the third.
- The new potential insurer is then required to send a copy of this disclosure to the original insurer. This allows the original insurer to contact the client and address any of their concerns. This attempt to "save" the original policy is called **conservation**. As long as it is done truthfully, this allows the client to better make an informed decision. Conservation is good and should be encouraged in the best

interest of the client. Copies of materials or information used in replacement or conservation should be left with the client. Remember, notifying the original insurer is not meant to protect the interests of the original agent; it's for the consumer protection.

- If an existing insurer attempts conservation, it has **20 days** to give the [policyowner](#) an outline of the current policy to help him or her make this fair comparison.

When annuities are involved, the disclosure information must be in the [contract](#) summary. The replacing insurer may request the existing insurer to furnish it with a copy of the summaries or ledger statement, which must be within 5 working days of the receipt of the request.

Replacement rules do not apply in the following situations:

- Replacing credit life insurance;
- Replacing group life insurance or group annuities;
- When converting or changing the current policy (with the same insurer); and
- Transactions where the replacing insurer and the existing insurer are the same (a new policy).

The burden of following the replacement rules falls on the replacing insurer to ensure that its agents are following these guidelines properly. This includes making sure the applications and disclosures properly ask replacement questions and returning to the agent any applications not correctly completed.

The replacing and existing insurers must retain evidence of all signed applications and disclosures, as well as other materials used in replacement or conservation, for **no less than 3 years**.

If the proposed new policy is underwritten and is then delivered to the client, the client has a **30-day free-look period** to evaluate the policies. Within this time period, if the client chooses to decline the new policy, the insurer must issue a full refund, no questions asked. The replacing insurer must provide a notice stating that the owner has a right to an unconditional refund of all premiums on the front of the policy jacket or on the cover page of its life [insurance policy](#) or annuity contract or, alternatively, as a separate written document which is delivered with the life insurance policy or annuity contract.

When an agent isn't used in the sales process (example: direct response or internet marketing), the replacing insurer must present to the client a [disclosure](#) similar to the one described earlier, as soon as a replacement is suspected, even if that means presenting the disclosure when the actual policy is delivered (usually via mail).

To maintain this standard, the insurer should still ask on the [application](#) what life insurance the applicant currently has, as well as whether a replacement is involved. Not using agents does not excuse companies of their replacement responsibility.

If the client, in his or her haste to save a month's premium, cancels the original policy or just fails to pay it, and then passes the [grace period](#), then the first policy will [lapse](#). The client will then get declined or rated by the new insurer during the underwriting process. If he or she decides against obtaining the new policy, then the person has lost the first policy and is now uninsurable. The client may have trouble reinstating and may be unable to get insurance with the new company. An agent should never leave a client in a worse condition (without any insurance) than the condition in which the client was found.

If a client insists on canceling or changing his or her current coverage before the proper time, the agent should have the client write and sign a letter saying he or she is acting contrary to the agent's advice. Hurting a client in the replacement process is an easy way for an agent to open himself or herself up to administrative troubles with the Department of Insurance and potential legal liability in court.

The following are replacement considerations:

- Even though the policies may be similar, the newer policy may be more expensive because the client is older and potentially not as insurable.
- Changing the current policy may make more sense than starting over with a new policy. The client might not have to worry about starting the incontestability period over as he or she might with a new company. Will the new company honor any incontestability periods that have already been met with the first company?
- Are premiums in either policy guaranteed, or can either change over time? If so, when or how often?
- If cash value, does the current policy have a surrender charge? Would a 1035 exchange benefit the client?

Sample Disclosure (CIC 10509.4(d))

NOTICE REGARDING REPLACEMENT REPLACING YOUR LIFE INSURANCE POLICY OR ANNUITY

Are you thinking about buying a new life [insurance policy](#) or annuity and discontinuing or changing an existing one? If you are, your decision could be a good one, or a mistake. You will not know for sure unless you make a careful comparison of your existing benefits and the proposed benefits.

Make sure you understand the facts. You should ask the company or agent that sold you your existing policy to give you information about it.

Hear both sides before you decide. This way you can be sure you are making a decision that is in your best interest. We are required by law to notify your existing company that you may be replacing their policy.

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(Applicant)	(Agent)	(Date)

2. Unnecessary Replacement (CIC 10509.8)

A violation occurs when an agent or insurer recommends the replacement or conservation of an existing policy based on a materially inaccurate presentation or comparison of the existing contract's premiums and benefits or dividends and values, or recommends that an insured 65 years of age or older purchase an unnecessary replacement annuity.

"Unnecessary Replacement" means the sale of an annuity to replace an existing annuity that requires the insured to pay a surrender charge for the annuity being replaced and does not confer a substantial financial benefit to the purchaser, so that a reasonable person would believe that the purchase is unnecessary.

A contract owner has the right to replace an existing annuity contract after indicating that replacement is not the intention. However, patterns of that action by contract owners using the same agent will be considered evidence that the agent knew

replacement was intended, and that the agent intended to violate the rules regarding replacement.

3. Penalties

Any person or entity that violates the replacement provisions of the Insurance Code is liable for the following administrative penalties:

Agents:

- A minimum of \$1,000 for a first violation;
- No less than \$5,000 and no more than \$50,000 per violation for a second or subsequent violation.

Insurer:

- \$10,000 for a first violation;
- No less than \$30,000 and no more than \$300,000 per violation for a second or subsequent violation.

The Commissioner may suspend or revoke the license of any person or entity that violates the articles of the Code.

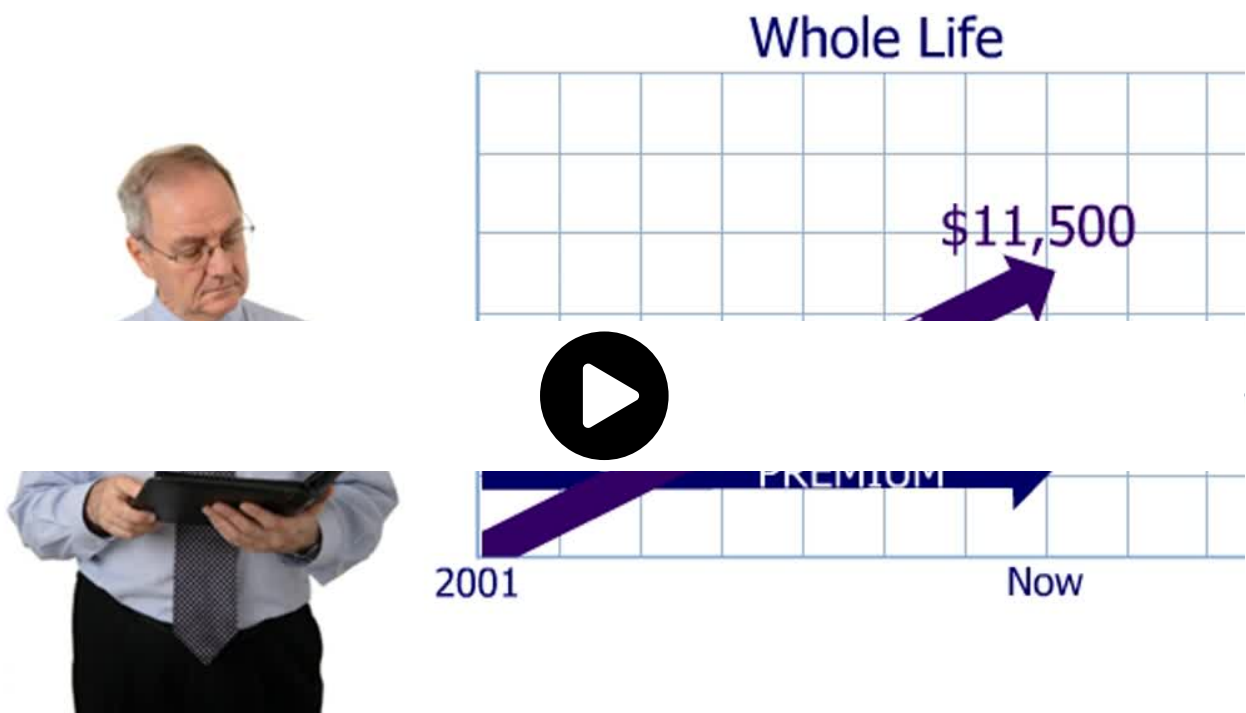
C. 1035 Exchanges

Many annuity sales are made possible through a tax-free exchange known as a 1035 Exchange, as codified in Section 1035 of the US Tax Code. A 1035 exchange involves the replacement of an existing insurance [contract](#) for the purchase of a new one, and permits tax advantages if the transaction qualifies as **like-kind exchange**. 1035 transactions have been instrumental in the sale of annuity products, and have contributed to much of the recent sales growth of variable annuities. In fact, 1035 exchanges are funding over 60% of new variable annuity sales. The numbers for fixed annuities are more in the range of 40%.

A 1035 exchange allows the contract owner to exchange outdated contracts for more current and efficient contracts, while preserving the original policy's tax basis and deferring recognition of gain for federal income tax purposes.

The following are exchange transactions that may qualify for favorable tax treatment under this code:

- A life [insurance policy](#) can be exchanged for another life insurance policy, an endowment insurance policy or a nonqualified annuity.
- An endowment insurance policy can be exchanged for a nonqualified annuity or another endowment policy.
- A nonqualified annuity can be exchanged for another nonqualified annuity.



1. Results of 1035 Exchange Transactions

When used appropriately, 1035 exchanges are highly effective in protecting against unfavorable tax consequences that could otherwise result when an old contract is terminated and new a contract is purchased.

Under most circumstances, the surrender of an existing insurance contract that has a gain in contract value is a taxable event. The gain must be recognized and reported as current income. However, if the purchase of a new contract qualifies as a 1035 exchange, the gain on the old contract is not currently taxable, and the cost basis is transferred to the new account. For this to take place, the exchange must occur between the two insurance companies involved. The exchange is not valid if the owner requests the proceeds from the insurance company by check and applies them to purchase a new contract.

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